DIRECT TESTIMONY

OF

JUDITH R. MARSHALL

TELECOMMUNICATIONS DIVISION

ILLINOIS COMMERCE COMMISSION

ILLINOIS BELL TELEPHONE COMPANY
d/b/a AMERITECH ILLINOIS

DOCKET NO. 01-0128

OCTOBER 25, 2001

Q. Please state your name and business address.

A. My name is Judith R. Marshall and my business address is 527 East Capitol Avenue, Springfield, Illinois 62701.

Q. By whom are you employed and in what capacity?

A. I am employed by the Illinois Commerce Commission ("Commission") as an Economic Analyst in the Telecommunications Division.

Q. Please describe your education, background and work experience.

A. In 1978 I received a Bachelor of Arts Degree in Accounting and in 1981 I received a Master of Arts, Business Administration Degree (later converted to an MBA) from Sangamon State University, now known as the University of Illinois - Springfield. I am a Certified Public Accountant, licensed to practice in Illinois.

I have approximately five years experience as an Internal Revenue Agent prior to my employment by the Commission in 1982. Prior to assuming my present position, I served as a Staff Accountant, an Audit Manager, and Supervisor of Training in the Accounts and Finance Department and as Supervisor of the Accounting Section in the Telecommunications Department of the Public Utilities Division of the Commission.

I am a member of the American Institute of Certified Public Accountants and the National Association of Regulatory Utility Commissioners ("NARUC") Staff subcommittee on Education.

Q. What is the purpose of your testimony in this proceeding?

A. My testimony addresses the policy issues for the Commission raised in Barrington-Wellesley Group, Inc.'s ("BWG") final report. These policy issues are listed in the Executive Summary on page I-12 of the report. I also recommend that the Commission order SBC/Ameritech to implement BWG's recommendations for the Company.

Staff witness Karen Buckley addresses the cost issues identified by BWG including Severance Costs, Relocation Costs, Compliance Costs, Pre-Merger Costs, E-Mail Conversion Costs, Operator Services, Bad Debt Expense, Savings Offset related to Stock Options, and Reciprocal Compensation.

Q. Do any schedules and attachments accompany your testimony?

A. Yes. Schedule 1 is a proprietary schedule that illustrates the impact of removing costs that have produced no savings from Ameritech's calculation of net merger savings for calendar 2000. Schedule 2 illustrates the impact of amortizing merger costs over a ten year period. Schedule 3 illustrates the impact of amortizing merger costs over a five year period. Schedule 4 illustrates the allocation of total SBC/Ameritech merger costs and savings to the Illinois intrastate jurisdiction. Each of these schedules is provided for illustrative purposes only.

Attachment 1 is Ameritech's calculation of net merger savings for calendar year 2000 and provides the account level data that is used in my Schedule 1. Attachment 2 is an SBC work paper that was provided in response to a Staff Data Request and included in ICC Staff Ex. 3.00, Attachment 1, in Docket 98-0555. Attachment 2 provides the data used in my Schedule 2.

Q. Please describe Schedule 1 attached to your testimony.

A. Staff Exhibit 1.0, Schedule 1 is my calculation of net merger savings for calendar year 2000. This schedule derives all of its detailed information from Ameritech prepared Attachment 1 and is based on booked actual costs which have not yet been audited by BWG. This schedule illustrates the significance of limiting the costs claimed by Ameritech to those costs that have produced savings. This calculation is preliminary. It should be superceded by BWG's more precise calculation of the amount of this adjustment at the sub initiative level and based on audited data.

Q. Please describe Schedule 2 attached to your direct testimony.

A. Staff Exhibit 1.0, Schedule 2 is my calculation of a ten year amortization of merger related costs based on SBC's original estimate of merger synergies. The data used to calculate Schedule 2 is derived from SBC prepared Attachment 2. All of the information included in Schedule 2 is based upon SBC's original estimate of merger synergies developed prior to the merger. This Schedule illustrates the impact of amortizing merger implementation cost over the same ten year period utilized by SBC in its analysis.

Schedule 2 is preliminary in nature and the amounts shown are less reliable than the revised estimates of merger related costs and savings contained in BWG's Final Report. A final calculation of the impact of adopting a ten year amortization period should be preformed after the Commission has determined appropriate regulatory treatment of specific items identified by BWG and should incorporate the most current estimate of merger related costs and savings.

Q. Please describe Schedule 3 attached to your direct testimony.

A. Staff Exhibit 1.0, Schedule 3 is my calculation of the impacts of selecting a five year amortization period for merger implementation costs. The data utilized in Schedule 3 is taken from BWG's Final Report as referenced in the footnotes. This data reflects a reduced level of implementation costs and an increased estimate of merger related savings. These estimates are taken from analyses done by individual merger integration teams and are the best estimates of merger related costs and savings available today. Additional adjustments to these amounts may result either from the regulatory treatment of items identified by BWG or from the use of actual audited data.

Q. Please discuss Schedule 4 attached to your direct testimony.

A. Lines 1 through 7 of Schedule 4 provide my calculation of the going level amount of net merger savings allocable to the Ameritech Illinois intrastate jurisdiction. The $90 million dollar allocation (Line 7) in the "original estimate" column was calculated by Ameritech witness Gebhardt. (See Docket 98-0555, SBC/Ameritech Exhibit 1.0, pages 62-64). I applied the same overall percentage to the amounts shown in the "BWG/MIT Summary" column to provide a revised estimate of the going level net savings attributable to the Ameritech Illinois intrastate jurisdiction. Please note that the going level in the "original estimate" column was expected to be reached in calendar year 2003 while the going level in the "BWG/MIT Summary" column is not expected to be reached until 2004.

Lines 10 through 20 of Schedule 4 provide similar data for calendar year 2000. The original estimate assumed that costs would significantly exceed savings for that year. The BWG amount based on merger integration team ("MIT") totals shows a small amount of net merger savings. Ameritech reported actual results reveal net merger related savings of $6.7 million (See Docket 01-0302 Order at page 12). It is also important to note that if Staff's position that only costs which have produced savings can be subtracted from merger savings is adopted, the refund ordered by the Commission will be approximately 3½ times greater than the refund amount ordered in Docket 01-0302. (See Schedule 1). The significance of the Commission's decision to rely upon actual data, rather than estimates, is illustrated by these comparisons of year 2000 unaudited data.

SBC/Ameritech Should Implement BWG's Recommendations.

Q. What was your role in the project which included BWG's review of merger related costs and savings?

A. I was named Project Manager for this project. In that role, I participated in drafting the Request for Proposal ("RFP") and selecting the successful bidder, BWG. I reviewed and commented on BWG's detailed work plan, participated in interviews with SBC/Ameritech personnel, supervised Staff who were present during much of the field work and reviewed selected work papers, attended planning and problem resolution meetings between BWG and SBC/Ameritech, and reviewed and commented on task reports and the draft report. I also handled administrative matters associated with this project.

Q. Has Ameritech Illinois ("AI") provided any response to BWG's final report?

A. Ameritech's testimony in this docket will be the first response it has made to BWG's final report. In accordance with the schedule established in this proceeding, Staff plans to respond to Ameritech in its rebuttal testimony.

Q. Do you have an overall opinion regarding BWG's recommendations for the Company?

A. Yes, I do. BWG's recommendations for the Company are listed at pages I-10 and I-11 in the Executive Summary of the Final Report. BWG will provide evidence supporting each of its recommendations during this proceeding and all parties will have an opportunity to address these recommendations. My overall opinion is that each of the recommendations of BWG is reasonable and should be implemented. I will address specific issues related to individual recommendations raised by the parties in my responsive testimony if necessary.

Based upon my participation in discussions of the draft report between SBC/Ameritech and BWG, I believe that it is unlikely that Ameritech will implement all of the recommendations of BWG. Therefore, I recommend that the Commission specifically order SBC/Ameritech to implement those recommendations that the Commission finds appropriate based on the evidence in this proceeding.

<u>Valuation of Intellectual Property</u>

Q. What decision is requested of the Commission regarding the valuation of Intellectual Property and Proprietary Information ("IP/PI")?

A. BWG has requested that the Commission determine whether Ameritech is entitled to compensation relating to the exchange of IP/PI or whether the transfer of IP/PI between companies in the merger is a "like for like" exchange without compensation. Background information on this issue is provided at pages V-17 V-18 of the report.

Q. Does SBC have procedures in place for tracking exchanges of IP/PI?

A. Yes, it does. SBC Operating Practice ("OP") 125 MP addresses this issue and provides that the Telco must be compensated for the IP/PI it provides that is used for other than the originating Telco's benefit. Such compensation is to be at the greater of fully distributed cost ("FDC") or fair market value ("FMV"). In the context of the SBC/Pacific Bell merger, like for like netting of IP/PI is permitted when used in a best practice review between *only the regulated telephone companies*. Like for like netting is subject to logging requirements. (Emphasis in original).

Q. Has Ameritech complied with these logging provisions?

A. Not to my knowledge. The report contains no evidence that the logging requirements have been met. According to the report, Ameritech plans to complete implementation of OP 125 in 2001. (BWG Final Report, page V-8.) Implementation of OP125 for Ameritech would satisfy the logging requirement. Staff will need to review the detailed items and materiality of Ameritech's exchanges of IP/PI before determining which items should be considered merger related cost savings. Staff expects the required log to provide identification of the specific items at issue.

Q. Should compensation for exchanges of IP/PI be shared with ratepayers through the allocation of merger costs and savings?

A. Yes. The exchanges of IP/PI are definitely merger related. Ameritech (and its rate payers) funded the development of its IP/PI. Therefore, it is my opinion that any compensation received by Ameritech for IP/PI should be considered a reduction of the costs incurring in development of the IP/PI, rather than a revenue enhancement. Such reductions in costs should be considered merger related savings and should, therefore, be shared with ratepayers.

Q. What is your recommendation regarding the valuation of IP/PI?

A. My recommendations are as follows:

- The Commission should find that any compensation due Ameritech for exchanges of IP/PI are defined as merger related savings.
- The Commission should order Ameritech to complete the logging requirements of OP 125 for each like for like exchange since the date of the merger.
- The Commission should evaluate individual exchanges of IP/PI to determine the impact of each individual exchange of IP/PI on net merger savings after Ameritech has completed the required log.

Costs in Excess of Savings

Q. What has BWG asked the Commission to determine regarding costs that have produced no savings as of the date the reports are filed?

A. BWG requests that the Commission develop guidelines for the Company to follow in reporting costs for sub-initiatives that have not produced savings in excess of costs at the date the reports are filed. This issue involves the question of the time period and level of detail for which the company must demonstrate that the costs of its merger initiatives are producing savings. In addition, BWG requests that the Commission consider extending the three year period for sharing of net merger savings to ensure an equitable apportionment to the Company and its ratepayers. (BWG Final Report, Chapter VIII-Merger Savings.)

BWG reports that the merger teams evaluated savings initiatives based on a five year payback period, raising the possibility that SBC might not realize savings associated with a number of initiatives until after the three-year period for the sharing of savings in Illinois is scheduled to end. There is at least one merger initiative for which savings are not expected until 2003. According to current plans, SBC will achieve only 96 percent of planned savings in the first three years, but will have expended 99 percent of the implementation costs. Normally, implementation expenditures are made before savings are realized. (BWG Final Report, VIII-26-27.)

Q. Has Staff previously addressed this issue?

A. Yes, I contributed to Staff's comments in Ameritech's annual Alt. Reg. Filings for calendar years 1999 and 2000, Dockets 00-0260 and 01-0302. In each of those cases, the Commission elected to defer its decision on this issue to this proceeding.

Q. What guidance does the Commission's Order in the merger docket provide on this issue?

A. Specifically, the Commission's Order in Docket 98-0555 states in pertinent parts:

> "To the extent that costs are incurred to produce savings and are shown to be both reasonable and directly related, we agree with the Joint Applicants that netting is appropriate. As a matter of logic, the only savings that can be experienced are net savings. Moreover,

our reading of Section 7-204(c) indicates that just such a result is contemplated. We further conclude on the arguments presented, that 50% of the net merger savings allocable to AI should be allocated to consumers using Staff's distribution methodology. This strikes a fair balance considering the commitment, performance and benchmark costs which will be incurred post-merger."…

"To be specific, Ameritech Illinois is required to track its share of all actual merger-related savings and all merger-related costs, as herein defined, separately for the period beginning on the date that the merger is consummated and ending on March 15, 2000. AI shall submit that information as part of its annual Alt. Reg. filing on April 1, 2000. Furthermore, this information will continue to be provided in Ameritech's annual price cap filings until such time as an updated price cap formula has been developed in Docket 98-0252. In the annual price cap filings, AI is required to flow-through merger savings net of reasonable costs in the manner here described until such time as an updated price cap formula has been developed." …

"It is the ruling of this Commission that the net merger-related savings should be allocated to Ameritech Illinois' customers as follows:

(1) Carriers purchasing AI's UNEs, interconnection, and transport and termination services will benefit from merger-related savings through updated rates resulting from modification of its TELRIC, shared and common costs.

(2) Once the share of the merger-related savings allocable to UNEs, interconnection, transport and termination purchasers have been identified, the remaining balance of savings will be allocated to interexchange, wholesale and retail customers. This will be done by dividing the remaining merger-related savings between IXCs on the one hand and end users (whether served via retail or wholesale) on the other, based on the relative gross revenues of each of these two groups.

As per Staff's recommendations, which we find to be reasonable, IXCs' share of the merger-related savings should be allocated to those customers through reductions in access charges, including the intrastate PICC. End users' share of the merger-related savings should be allocated as a credit on a per network access line basis to ensure that business customers do not receive a larger portion of the merger-related savings than residential customers.

(Order at 146-150).

Q. What is your interpretation of these parts of the Commission's Merger Order?

A. As cited above, the Commission's Order in Docket 98-0555 requires that only costs that are incurred to produce savings and are shown to be both reasonable in nature and in amount, and directly related to the production of merger related savings, are appropriately netted against merger related savings. It is my opinion that costs which have produced no savings should not be netted against other savings. Ameritech should be required to re-calculate the net merger related savings reported for calendar 1999 so that costs which have produced no savings are not reflected.

My calculation of calendar year 2000 intrastate net merger savings illustrates the impact of including costs for those accounts where savings were produced while eliminating costs that have not been shown to produce any savings whatsoever. My calculation is subject to the audit of calendar year 2000 net merger related savings. For example, BWG has recommended the merger related costs and savings be reported at the sub-initiative level which provides a more precise calculation than Schedule 1, which is prepared at the four digit uniform system of accounts ("USOA") level.

It may be important to note that I do not propose a permanent disallowance of these costs, but only that they should be deferred until such time as they produce savings.

Q. Is there an alternative treatment of merger related costs that you believe is equally appropriate?

A. Yes, there is. I addressed an alternative treatment of merger related savings in my testimony in the merger docket (Docket 98-0555). I testified that, in analyzing the proposed merger, the Joint Applicants calculated synergies through the year 2010 which continue to increase in each year. In my opinion, use of a three year time frame is not equitable because all of the one-time costs of achieving on-going economies occur within the first three years. To the extent that these costs are determined to be reasonable, they should be amortized over the same ten year period during which synergies are expected to be realized. (Docket 98-0555, Staff Ex. 1.02, p. 30.) The Order in Docket 98-0555 neither accepts nor rejects the amortization the amortization of merger related costs. In my opinion, the Order in Docket 98-0555 defers consideration of this issue to a future docket.

Amortization of costs over the period for which they are expected to produce benefits is a normal regulatory practice the Commission has frequently authorized. The amortization of costs assures that the amount of cost recovered in each year is reasonable. Although the Merger Order does not directly address this issue, it is reasonable to imply that the Commission intended that this normal regulatory practice be followed. The Commission's Order in Docket 98-0555 requires that costs be both reasonable and directly related to savings. (Merger Order at 148). Staff also notes that the Commission's Order in Central Telephone Company of Illinois ("Centel") Docket 93-0252 required amortization of the allowable costs of producing merger savings. The Commission's Merger Order neither rejects nor orders amortization of costs. Therefore, in my opinion, the use of a ten year amortization to assure that costs are reasonable in amount is a reasonable option for the Commission.

Q. Is there additional support for amortization of merger related costs over a ten year period.

A. Yes. The Citizen's Utility Board and Attorney General of Illinois ("CUB/AG") also addressed this issue in Docket 01-0302, contending that the costs associated with savings initiatives should be amortized over 10 years. CUB/AG argued that it was not fair or equitable to front-load these costs, when the resulting savings will be realized over a longer period of time. In that same docket, Ameritech suggested that, to the extent that the Commission wishes to consider this matter further, it should be deferred to the audit proceeding where a full record can be developed. (Order Docket 01-0302, p. 11.)

Q. Do you believe that the Commission should consider extending the three year period for the sharing of net merger savings as recommended by BWG?

A. Yes, I do. I addressed this issue in Docket 98-0252, the Commission's review of Ameritech's Alt. Reg. Plan. My testimony noted the delay of BWG's audit due to the unavailability of actual audited data on an expedited basis and to the time required by SBC to implement a system for tracking merger costs and savings. Therefore, I recommended that the terms of the merger condition remain in effect until the Commission completes its next review of the alternative regulation plan. It was Staff's position that the plan adopted by the Commission in Docket 98-0252 would be reviewed in approximately four years, with a final order in place prior to July 1st of the fifth year. (Docket 98-0252, Staff Ex.4.0, p. 8).

On rebuttal, I testified that current SBC projections indicate that the going level of merger related costs and savings will not be reached until 2004. The term "going level" refers to that point in time where no additional merger implementation costs are expected to occur and merger related savings are not expected to increase by an amount greater than reasonable estimates of inflation. Approximately 96% of the going level will have been reached at the end of 2002 if implementation of best practices identified by SBC's merger integration teams is achieved on schedule. (BWG Final Report, page VIII-27). Significant savings are projected in the areas of procurement and benefits and these savings are less likely to be fully reflected in 2002 actual amounts because of delays in implementation of planned best practices. (Docket 98-0252, ICC Staff Ex. 18.0, pages 8-11).

Effective with the price cap filing of April 1, 2006, the Commission could make a one-time adjustment to the price cap index to reflect the going level of merger costs and savings and discontinue the annual audit requirement. The final year of audited merger costs and savings would be 2004, which is equivalent to the time frame associated with continuing this requirement until a five year review is made of the alternative regulatory plan. (Id.) The post exceptions proposed order ("PEPO") in Docket 98-0252 considers this issue an "open" issue that may be resolved through a one-time rate adjustment. On an interim basis, merger costs and savings will continue to be reported and dealt with on an annual basis.

Q. Is there another alternative that the Commission could consider for the treatment of merger costs and savings?

A. Yes. As an alternative to Staff's recommendation that the period for reporting merger related costs and savings be extended through calendar year 2004, the Commission could consider modifying its requirement that actual merger costs and savings be audited annually. If such a modification were adopted, the Commission could adjust the alternative regulatory formula at this time to reflect 50% of SBC's current estimate of merger costs and savings at the going level. It is my understanding that merger costs and savings amounts have already been reviewed by SBC's upper management levels and thoroughly analyzed by SBC's merger integration teams. These estimates by SBC's merger integration teams were approved by SBC's upper management. As noted at page VIII-21 of BWG's final report, "[SBC's] Transition Policy Group ("TPG") made clear to the teams that targets were firm and not negotiable. The only exception was that benchmarking errors could be corrected, but only if it made a difference." Therefore, the current estimate of net merger related costs and savings has a high probability of being achieved.

Adoption of a merger costs and savings factor at this time would reduce the regulatory burden of determining the actual amount of costs and savings on an annual basis. It would conserve both Commission and Company resources expended in the annual audits and would simplify the annual price cap filing proceedings. Although I am not an attorney, it is my understanding that Condition 26 of the existing merger order (Docket 98-0555 Order), which requires annual audits of actual merger costs and savings, may expire if the Commission chooses a different approach to merger costs and savings in Docket 98-0252.

Q. If the Commission chooses to make a one-time adjustment to reflect the going level merger related costs and savings, how should that adjustment be quantified?

A. Ameritech should provide an allocation of the revised amount of planned merger related costs and savings to Illinois Intrastate operations. Such an allocation was provided by Ameritech in the merger case, Docket 98-0555. Ameritech's revised cost estimates as contained in BWG's Final Report should be utilized for this calculation. 50% of the "going level" net merger savings amount allocable to the Illinois intrastate jurisdiction should be used for a one-time, permanent annual rate adjustment. Since the planned net merger savings have increased, Staff anticipates a comparable increase in the going level amount previously calculated to be $90 million.

Q. Do you have any additional comments?

A. Yes. Certain Commissioner's have commented from the bench that they would encourage Ameritech to propose a settlement of the merger related costs and savings issue. I urge the parties in this proceeding to consider such a permanent settlement in order to eliminate future audits and continuing controversy.

<u>Treatment of Pension Plan Settlement Gains</u>

Q. What has BWG asked the Commission to determine regarding the treatment of pension plan settlement gains?

A. BWG asks the Commission to determine whether or not pension plan settlement gains and expense reductions attributable to changes in actuarial assumptions to conform the SBC and Ameritech pension plans are merger-related and develop appropriate guidelines and reporting requirements for the Company to follow.

Q. Please comment on this issue.

A. In my opinion, this issue is separable into two types of savings. Expense reductions attributable to conforming SBC and Ameritech pension plans are merger related. The Commission has ordered in Docket 98-0555 that all merger related cost savings be shared with ratepayers. Therefore, these cost savings must be reported and shared with ratepayers. BWG has engaged a pension specialist to address these issues and I believe that quantification and reporting requirements would be best addressed by the pension specialist.

A second issue relates to recognition of pension gains that are triggered by the separation of employees. Ameritech's accounting procedures delay any recognition of pension gains until separation occurs. These procedures are in accordance with generally accepted accounting principles ("GAAP") and I do propose any change in these procedures. In this case, BWG should determine the separations related to the merger and the amount of pension gains triggered by the merger related separations. In my opinion, the Commission should determine that recognition of these pension gains is merger related.

The Commission must next determine whether pension gains are in fact revenue enhancements or actually reductions in the amount of pension expense previously recorded by Ameritech. It is my opinion that pension gains are nothing more than an adjustment of the amount of pension expense previously recorded by Ameritech and recovered from ratepayers. Therefore, the Commission should determine that pension gains are merger related cost savings.

<u>Interest Expense and Cost of Capital</u>

Q. What direction does BWG seek regarding Interest Expense and Cost of Capital?

A. BWG asks the Commission to consider whether or not an imputed reduction in interest expense relating to revenue enhancement initiatives within the regulated telephone operating companies is a merger related expense savings to be shared with ratepayers in Illinois. They also ask that the Commission consider whether or not an imputed savings in the cost of capital related to improved cash flow from reduced capital expenditures constitutes savings to be shared with ratepayers in Illinois.

Q. Do you have an opinion about these issues?

A. Yes. Because Ameritech is a price regulated company in Illinois, I do not believe that the Commission should impute either the reduced interest expense or cost of capital. Under price regulation neither interest expense nor cost of capital has any impact on customer rates. It is my opinion that these items are more appropriate for consideration in a rate of return environment. However, I will consider the testimony of other witnesses in responsive testimony.

Summary

Q. Please summarize your recommendations.

A. My recommendations are summarized as follows:

- The Commission should order SBC/Ameritech to implement BWG's recommendations for the Company.
- The Commission should direct SBC/Ameritech to complete IP/PI logs for all exchanges subsequent to the merger.
- Any compensation due to Ameritech for IP/PI should be considered a merger related saving.
- Costs that are not directly related to savings should not be netted against savings from other sub-initiatives and should be deferred until such time as they produce savings.
- Alternatively, merger related costs should be amortized over a ten year period.

- The Commission should extend the period for reporting actual merger related costs and savings until calendar 2004 costs have been audited.
- The parties in this proceeding should consider a permanent settlement of merger related costs and savings issues.
- Pension expense reductions attributable to conforming SBC and Ameritech pension plans are merger related savings.
- Pension gains attributable to separated employees are merger related cost savings.
- Pension gains should be considered a reduction of pension expense and should be included in the calculation of net merger savings.
- The Commission should not impute reduced interest expense or cost of capital for inclusion in merger related savings.

<u>Conclusion</u>

Q. Does this conclude your testimony?

A. Yes, it does.

Schedule 1

<u>THIS SCHEDULE CONTAINS PROPRIETARY DATA</u>

Schedule 2

THIS SCHEDULE CONTAINS PROPRIETARY DATA

Schedule 3

THIS SCHEDULE CONTAINS PROPRIETARY DATA

Schedule 4

THIS SCHEDULE CONTAINS PROPRIETARY DATA

Attachment 1

THIS SCHEDULE CONTAINS PROPRIETARY DATA

Attachment 2

THIS SCHEDULE CONTAINS PROPRIETARY DATA